No. 86-1054

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In the Supreme Court of the United States

OCTOBER TERM, 1986

ASPHALT PRODUCTS CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Commissioner abused his discretion in requiring petitioner to change from the cash method of accounting to the accrual method of accounting.

2. Whether the court of appeals erred in concluding that petitioner acted negligently in claiming as a deduction an amount expended by it for the personal benefit of its shareholders.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 4a-25a) is reported at 796 F.2d 843. The memorandum opinion of the Tax Court (reprinted in part at Pet. App. 28a-38a, Pet. Supp. Br. App. 1a-5a; reprinted in full at 86-1053 Pet. App. 31a-81a) is reported at 47 T.C.M. (CCH) 1621.

JURISDICTION

The judgment of the court of appeals (Pet. App. 2a-3a) was entered on July 17, 1986. A petition for rehearing was denied on September 25, 1986 (Pet. App. 1a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. Petitioner is a corporation with its principal place of business in Nashville, Tennessee. During 1974-1976, petitioner was in the business of producing and selling emulsified asphalt, a road-paving material. Petitioner's sales of asphalt were seasonal, since its customers did little paving work during the winter months of December, January, and February (Pet. App. 31a).

Because emulsified asphalt cannot be kept through the winter, petitioner normally finished its production run in mid-December and shut down its plant until early January, carrying very little inventory of raw material and no finished product over its year-end on December 31 (Pet. App. 5a-6a).

In 1973, the Arab oil embargo forced several changes in petitioner's previous business practices. As a result of the shortages created by the embargo, petitioner's asphalt suppliers instituted a system of allocations under which petitioner was required to take part of its annual supply of raw asphalt during the winter months or lose the right to obtain the amount it needed to operate during the rest of the year. As a result, its year-end inventory rose from near-zero levels prior to 1973 to $25,813 at the end of 1974 and to $36,000 at the end of 1975 (Pet. App. 6a). A second, and even more significant, change occurred because several Tennessee counties, which were petitioner's principal customers, were faced with sharp increases in the price of petitioner's product at a time when their gasoline tax revenues were declining. As a result, many counties delayed payment of their invoices, and petitioner's accounts receivable rose from $71,482 at the end of 1973 to $264,269 at the end of 1974, remaining as high as $238,000 at the end of 1976. Pet. App. 6a, 15a, 31a-32a.

For federal tax purposes, petitioner reported its income for 1974, as it had done in previous years, under the cash receipts and disbursements method of accounting. On examination of its return, the Commissioner determined that this method of accounting did not clearly reflect petitioner's income for 1974, and, pursuant to Section 446 of the Code,[1] determined that petitioner's income should have been computed under the accrual method of accounting. The recomputation of petitioner's income under the

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

accrual method produced a substantial increase in its taxable income for 1974 and a corresponding deficiency in its income tax. Pet. App. 6a, 32-33a.

b. Petitioner filed a petition in the Tax Court for redetermination of the deficiency, contending that the Commissioner had abused his discretion in requiring it to change from the cash method of accounting to the accrual method. The Tax Court rejected this contention (Pet. App. 33a-38a). The court concluded that "the underlying nature of petitioner's business ha[d] changed from the earlier, less volatile and less inflationary years" and that petitioner's prior use of the cash method therefore did not "preclude a determination that another method must now be used" (*id.* at 36a, 37a n.13). Specifically, the court found that "[i]nventory [was] a material income-producing factor in petitioner's business" during 1974 and that, "[b]ecause it was necessary to maintain inventories, petitioner's income could not be clearly reflected by the use of the cash method" (*id.* at 37a). The court also noted that "the fluctuation in accounts receivable [was] substantial in relation to petitioner's income" (*ibid.*). The court accordingly concluded that the Commissioner did not abuse his discretion in determining that the cash method of accounting did not clearly reflect petitioner's income during 1974 and that use of the accrual method was therefore required (*ibid.*).

The court of appeals affirmed the Tax Court's decision on this issue by a 2-1 vote (Pet. App. 4a-25a). The majority noted (*id.* at 10a) that Section 446 of the Code gives the Commissioner broad discretion to require a taxpayer to change its method of accounting when "in the opinion of the [Commissioner]" the taxpayer's existing method "does not clearly reflect income" (I.R.C. § 446(b)). The court suggested that the presence of substantial inventory at year-end 1974, standing alone, might not have necessitated petitioner's abandonment of the cash method of accounting, since the court viewed that increase as a temporary

phenomenon attributable to the oil embargo (Pet. App. 14a-15a). But the court concluded that "the large increase in accounts receivable created a situation where only use of the accrual method of accounting would avoid a serious distortion" (*id.* at 14a). The court explained that petitioner's 1974 income and expenses were mismatched by use of the cash method, since "the cost of materials sold in 1974 was deducted on the 1974 return, yet the proceeds from that portion of the same sales represented by the accounts receivable were not included in [petitioner's] gross receipts as reported on [that] return" (*id.* at 14a-15a). The court also noted that petitioner's accounts receivable, unlike its inventory, "were not negligible before 1974 and did not shrink even to their former size at the end of the oil emergency," but rather stood at $238,000 at the end of 1976 (*id.* at 15a). The court held that, "[u]nder these circumstances, the Commissioner's finding that the cash method no longer clearly reflected [petitioner's] income was fully supported by the record and the requirement that [petitioner] adopt the accrual method for 1974 and subsequent years was not an abuse of discretion" (*id.* at 14a).[2]

2. Petitioner also claimed a deduction on its 1974 tax return for the expenses of transporting personal property of its principal shareholders from California to Tennessee. The facts underlying this deduction are as follows. Petitioner's principal shareholders had purchased two trailer-mounted wastewater treatment plants that were temporarily situated in California. The shareholders bought this equipment in their individual capacities, for use in a Tennessee development; the trailers were completely unrelated to petitioner's business as an asphalt manufac-

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[2] Judge Nelson dissented on this issue (Pet. App. 17a-25a). In his view, the changes in inventory and accounts receivable were not substantial enough to render use of the cash method impermissible when that method had been used in previous years.

turer. The following year, the shareholders donated the treatment plants, which were purchased for $17,500, to Vanderbilt University, and claimed a charitable deduction on their personal income tax returns of $201,000 (No. 86-1053 Pet. App. 58a).

At about the same time that the shareholders purchased the wastewater treatment plants, petitioner purchased two highway trucks suitable for towing large, heavy trailers. The trucks were manufactured in Seattle, Washington (C.A. App. 49; Pet. Supp. Br. 7). Instead of having the trucks sent from Seattle for delivery through a dealership in Nashville, petitioner arranged to take delivery of the trucks on the West Coast, apparently in Seattle (*ibid.*). Petitioner then sent two of its employees from Nashville to the West Coast to pick up the new trucks, drive them to where the shareholders' trailers were located, hook the trailers onto the trucks, and then haul the trailers to Tennessee (Pet. App. 6a-7a). Petitioner deducted the truckdrivers' salaries and expenses, in the aggregate amount of $1,103, as a corporate business expense (*id.* at 7a; Pet. Supp. Br. App. 4a n.25).

The Commissioner disallowed the claimed deduction, concluding that petitioner had improperly deducted amounts expended for the personal benefit of its shareholders. The Commissioner also asserted a penalty, in an amount equal to 5% of petitioner's underpayment of tax, pursuant to Section 6653(a) of the Code. This penalty was based on the determination that petitioner had acted negligently in claiming the deduction in question.

In the Tax Court, petitioner stipulated that these expenses were not properly deductible by it,[3] but maintained

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[3] Petitioner later sought to retract this concession, asserting in its Tax Court brief that "this amount [was], after all, properly deductible" (Pet. Supp. Br. App. 4a n.25). The Tax Court, however, held petitioner to its stipulation, concluding that "justice does not require us to consider the stipulation to be without binding effect" (*ibid.*, citing T.C. Rule 91(e)).

that it had not been negligent in claiming the deduction (Pet. Supp. Br. App. 4a). The Tax Court rejected that contention, concluding that petitioner had failed to meet its burden of proving that its improper deduction of these expenses was not attributable to negligence or the intentional disregard of IRS rules and regulations. The Tax Court noted its prior holdings that "the deduction by a corporation of personal expenditures as business expenses is clearly negligence" (*id.* at 5a n.26), and it accordingly upheld the Commissioner's imposition of the negligence penalty.

The court of appeals unanimously sustained the Tax Court's finding that petitioner's attempt to deduct the personal expenses of its shareholders constituted negligence and therefore that it was subject to the Section 6653(a) penalty. The court reversed the Tax Court in part, however, reducing the amount of the penalty imposed. Pet. App. 13a-15a.[4]

ARGUMENT

1. The court of appeals correctly held that the Commissioner did not abuse his discretion in changing petitioner's method of accounting, and there is no reason for further review of that issue by this Court.

a. This Court has long recognized that Congress has vested the Commissioner with great discretion in matters of tax accounting. Section 446(b) provides that "if the method [of accounting] used [by the taxpayer] does not

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[4] The court held that the amount of the penalty should be reduced to about $25-5% of the portion of the underpayment attributable to the negligently-claimed $1,103 deduction—stating that it would be unduly harsh to subject petitioner to a penalty equal to 5% of the entire $133,249 underpayment (Pet. App. 15a-16a). We believe that this latter holding misinterprets Section 6653, and that holding is the subject of the government's pending petition for certiorari in No. 86-1053. See note 7, *infra*.

clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." And Section 471 provides that "[w]henever in the opinion of the [Commissioner] the use of the inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken on such basis as the [Commissioner] may prescribe."

These provisions obviously "give the Commissioner broad discretion to set aside the taxpayer's method [of accounting] if, 'in [his] opinion,' it does not reflect income clearly." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 540 (1979) (quoting I.R.C. § 446(b)). Accord *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959); *Lucas* v. *American Code Co.*, 280 U.S. 445, 449 (1930). The Commissioner's "interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.' " *Thor Power Tool Co.*, 439 U.S. at 532 (quoting *Lucas* v. *American Code Co.*, 280 U.S. at 449). This is because " '[i]t is not the province of the court to weigh and determine the relative merits of systems of accounting.' " *United States* v. *Catto*, 384 U.S. 102, 114 (1966) (quoting *Brown* v. *Helvering*, 291 U.S. 193, 204-205 (1934)). Thus, as the court of appeals stated (Pet. App. 13a), "[w]hen the Commissioner concludes that a taxpayer's method of accounting does not clearly reflect income, the taxpayer has a heavy burden to show that the Commissioner has abused his discretion."

The courts below correctly concluded that there was no basis for interfering with the Commissioner's determination that petitioner's existing cash method of accounting did not clearly reflect its income for 1974 and that it was necessary for petitioner to change to the accrual method in order to reflect that income accurately. As the court of appeals explained (Pet. App. 14a-15a), petitioner's use of the cash method of accounting in 1974 produced a material

distortion of its income. Petitioner deducted on its return for 1974 the cost of materials sold in that year, but it excluded from its income a large part of the proceeds of those sales, since its customers purchased mainly on credit and did not pay for their purchases until a later year. As the Tax Court found, moreover, "[i]nventory [was] a material income-producing factor in petitioner's business" during 1974 (Pet. App. 37a). The Treasury Regulations have long provided that "[i]n any case in which it is necessary to use an inventory, the accrual method of accounting must be used," absent express authorization from the Commissioner. Treas. Reg. § 1.446-1(c)(2)(i) and (ii). For both reasons, therefore, the Commissioner did not abuse his discretion in requiring petitioner to employ the accrual method of accounting.

b. Petitioner concedes (Pet. 10) that "the Commissioner has wide discretion in determining whether a particular method of accounting 'clearly reflects income.' " Petitioner likewise does not seriously dispute that its use of the cash method of accounting resulted in a material distortion of its taxable income for 1974. The main thrust of petitioner's argument (Pet. 10-16) is that this latter fact alone does not authorize the Commissioner to change a taxpayer's method of accounting. In petitioner's view, the word "clearly" should be deemed to mean "honestly," not "accurately," so that a taxpayer's method of accounting would "clearly reflect income," regardless of its inaccuracy, as long as the method had been used consistently and honestly, without any improper intent to manipulate or distort. See Pet. 7, 10-11.

In essence, petitioner is contending that the Commissioner is powerless under Section 446 to challenge a method of accounting that does not accurately reflect the taxpayer's income, unless it can be shown that the taxpayer intentionally has sought to distort its income. But neither the terms of Section 446 nor the relevant decisions

of this Court remotely suggest that the exercise of the Commissioner's broad discretion to adjust a taxpayer's method of accounting is dependent on the existence of an evil or deceitful motive. For example, the Court's explicit holding in *Thor Power Tool Co.* that the Commissioner may find that a taxpayer's accounting method does not "clearly reflect income" even if it conforms to "generally accepted accounting principles" (439 U.S. at 544) cannot possibly be squared with petitioner's contention. Indeed, the Court in that case specifically rejected the contention that the Commissioner can prevail only by showing that the taxpayer's method "demonstrably distorts income" or was "motivated by tax avoidance" (439 U.S. at 539-540).

Petitioner asserts that there exists a conflict in the circuits on this issue, relying on *Osterloh* v. *Lucas,* 37 F.2d 277, 278-279 (9th Cir. 1930). The court there stated that the method of accounting chosen by the taxpayer is controlling "unless there has been an attempt of some sort to evade the tax." In the nearly 60 years since *Osterloh* was decided, however, it has never been followed by any court of appeals. And two courts of appeals, in addition to the court below, have expressly rejected the proposition advanced in *Osterloh.* See *Wilkinson-Beane, Inc.* v. *Commissioner,* 420 F.2d 352, 356 (1st Cir. 1970); *Caldwell* v. *Commissioner,* 202 F.2d 112, 114-115 (2d Cir. 1953). Moreover, as explained above, the "intent to evade" standard suggested in *Osterloh* cannot be reconciled with the more recent decisions of this Court addressing the extent of the Commissioner's authority to challenge a taxpayer's method of accounting. See, *e.g., Thor Power Tool Co.* v. *Commissioner, supra.* Thus, the Ninth Circuit's decision in *Osterloh* does not appear to have any continuing vitality; indeed, recent decisions in the Ninth Circuit itself do not appear to recognize *Osterloh* as controlling authority on the meaning of the phrase "clearly reflect in-

come." See *Homes by Ayres* v. *Commissioner*, 795 F.2d 832 (1986).[5]

2. Petitioner contends in a supplement to the petition (Pet. Supp. Br. 3-9) that the court of appeals erred in sustaining the Tax Court's finding that petitioner acted negligently in deducting as a business expense the amounts expended for the personal benefit of petitioner's shareholders in transporting to Tennessee the wastewater treatment plants the shareholders had purchased in California. Petitioner therefore argues that no Section 6653 penalty should have been imposed here. This completely factbound issue was correctly resolved by the courts below, and there is no reason for this Court to review the question whether petitioner was subject to the Section 6653(a) negligence penalty.

It is well established that the deficiency determinations of the Commissioner are presumed to be correct, and the taxpayer has the burden of proving error. See, *e.g.*, *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933). This presumption extends to the assertion by the Commissioner of the negligence penalty imposed under Section 6653(a) of the Code. *Rapp* v. *Commissioner*, 774 F.2d 932, 935 (9th Cir. 1985); *Cates* v. *Commissioner*, 716 F.2d 1387, 1390 (11th Cir. 1983); *Forseth* v. *Commissioner*, 85 T.C. 127, 166 (1985). The Tax Court here found that petitioner had failed to meet its burden of demonstrating that its im-

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[5] Petitioner also contends (Pet. 15-17) that the Sixth Circuit's decision below is inconsistent with prior Sixth Circuit decisions in *Morris-Poston Coal Co.* v. *Commissioner*, 42 F.2d 620 (1930), and *Glenn* v. *Kentucky Color & Chemical Co.*, 186 F.2d 975 (1951). Even if that were true, such an intra-circuit conflict would provide no reason for review by this Court. In fact, as the court of appeals explained (Pet. App. 12a-13a), these decisions did not adopt the rule proposed in *Osterloh*, and they are fully consistent with the decision below.

proper deduction of the personal expenses of its shareholders was not due to negligence (Pet. Supp. Br. App. 3a-5a). Because the record does not establish that petitioner exercised due diligence in claiming this deduction, the court below correctly affirmed the Tax Court's finding that petitioner's action in this regard was negligent.

Petitioner at one point suggests (Pet. Supp. Br. 6-8) that its deduction not only was non-negligent but in fact was proper. Petitioner asserts that it incurred no additional nonbusiness expenses in transporting the shareholders' trailers from *California* to Tennessee, on the theory that it would have incurred business expenses in the same amount by transporting its new trucks from *Seattle* to Tennessee. Petitioner stipulated in the Tax Court, however, that no portion of the expenses relating to the transportation of trailers was properly deductible, and the Tax Court accordingly declined to consider this contention (Pet. Supp. Br. App. 4a n.25). The contention in any event is wholly without merit. If petitioner had taken delivery of the trucks through a Nashville dealership in the usual way (see C.A. App. 49; Pet. Supp. Br. 7), the expense of transportation from Seattle would not have been a deductible business expense, but would have been capitalized as part of petitioner's cost of the trucks. The only conceivable reason for petitioner's having taken delivery of the trucks on the West Coast was to confer a benefit on its shareholders, whose trailers were located in California. The deduction generated by sending petitioner's employees to the West Coast to haul the shareholders' trailers back to Tennessee thus was plainly improper.[6]

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[6] Contrary to petitioner's assertion (Pet. Supp. Br. 4-6), the Tax Court did not rule that petitioner's concession that the expenses in question were not deductible rendered it liable as a matter of law for

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.[7]

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negligence penalty. Rather, the court simply ruled that it was incumbent upon petitioner to prove that its deduction of the admittedly improper expense was not due to negligence and that it had failed to meet that burden. That ruling was plainly correct, and it is fully consistent with the principles established in other decisions of the Tax Court and the courts of appeals.

[7] The government has also petitioned from the judgment below to challenge the court of appeals' calculation of the negligence penalty (No. 86-1053). As explained in that petition, the court of appeals' holding that the negligence penalty should be limited to 5% of the portion of the underpayment attributable to the negligence, rather than computed as 5% of the entire amount of the underpayment, is completely at odds with the language of the statute and with 68 years of consistent interpretation by the courts. In our view, the pendency of the government's petition in No. 86-1053 provides no reason for the Court to grant review of petitioner's distinct, and highly factbound, contention that there was no negligence here at all that could justify the imposition of *any* penalty under Section 6653.

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